

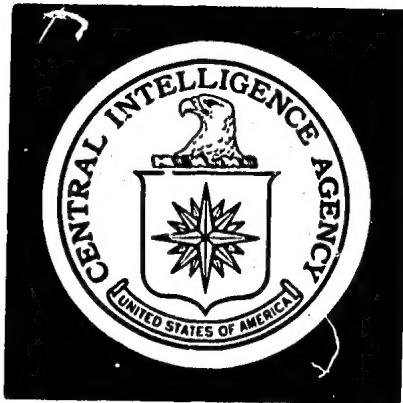
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**DIRECTORATE OF
INTELLIGENCE**

Intelligence Memorandum

Hong Kong: Economic Growth Prospects

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ER IM 71-224
December 1971

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
December 1971

INTELLIGENCE MEMORANDUM

HONG KONG: ECONOMIC GROWTH PROSPECTS

Introduction

1. Over the past decade or so, Hong Kong has sustained a very rapid economic growth rate, based almost entirely on exports. The colony now ranks first among less developed countries as an exporter of manufactures. This has been accomplished despite the British Crown Colony's tiny size, the lack of natural resources, and the virtual absence of foreign economic assistance. Prosperity, however, is now creating problems. Domestically, wages are increasing rapidly, while, internationally, the United States and other countries are placing restrictions on Hong Kong's exports. Further complicating the situation is Communist China's emergence into the world community, which could eventually change its economic relationship with Hong Kong. This memorandum examines the basis of Hong Kong's economic prosperity and the importance of the US role and evaluates the prospects for continued rapid economic growth.

Discussion

Prosperity with Uncertainty

2. Hong Kong is unique among less developed countries. In sharp contrast to most of the rest, it has highly sophisticated economic, financial, and commercial institutions; very perceptive local entrepreneurs; a literacy rate topping 75%; and an extremely hard working and disciplined labor force. Beyond this, Hong Kong is an almost completely open economy, as government restrictions on both foreign and domestic businessmen are minimal. As China's door to the non-Communist world, the Crown Colony serves the mainland as an entrepot and a financial center.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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3. Under these favorable circumstances, the 1960s saw a tremendous increase in economic activity (see the table). The average annual growth of real GNP was more than 10% during the decade and about 13% in recent years. Exports of domestic manufactures were more than four times their 1960 level, imports almost tripled, the number of tourists grew almost fivefold, and bank deposits rose from less than \$500 million in 1960 to almost \$2.5 billion in 1970 (see Figure 1). This prosperity has raised Hong Kong's per capita GNP in current prices to more than \$900 -- only slightly below that of Spain or Greece. While consumer prices rose 30% during the decade, money wages doubled, bringing a substantial increase in real wages. Housing for more than 1 million people has been built by the government, and this once pressing problem has lost much of its urgency. Social services of all kinds have been greatly increased, and the colony now compares favorably with developed nations in this respect.

Selected Economic Data

	<u>1960</u>	<u>1970</u>
Population (thousand)	3,075.3	3,941.6
Gross national product (million US \$, current prices) a/	866	3,620
Per capita GNP (US \$ current prices) a/	282	918
Domestic exports (million US \$)	499	2,037
Bank deposits (million US \$)	466	2,468

a. Estimated.

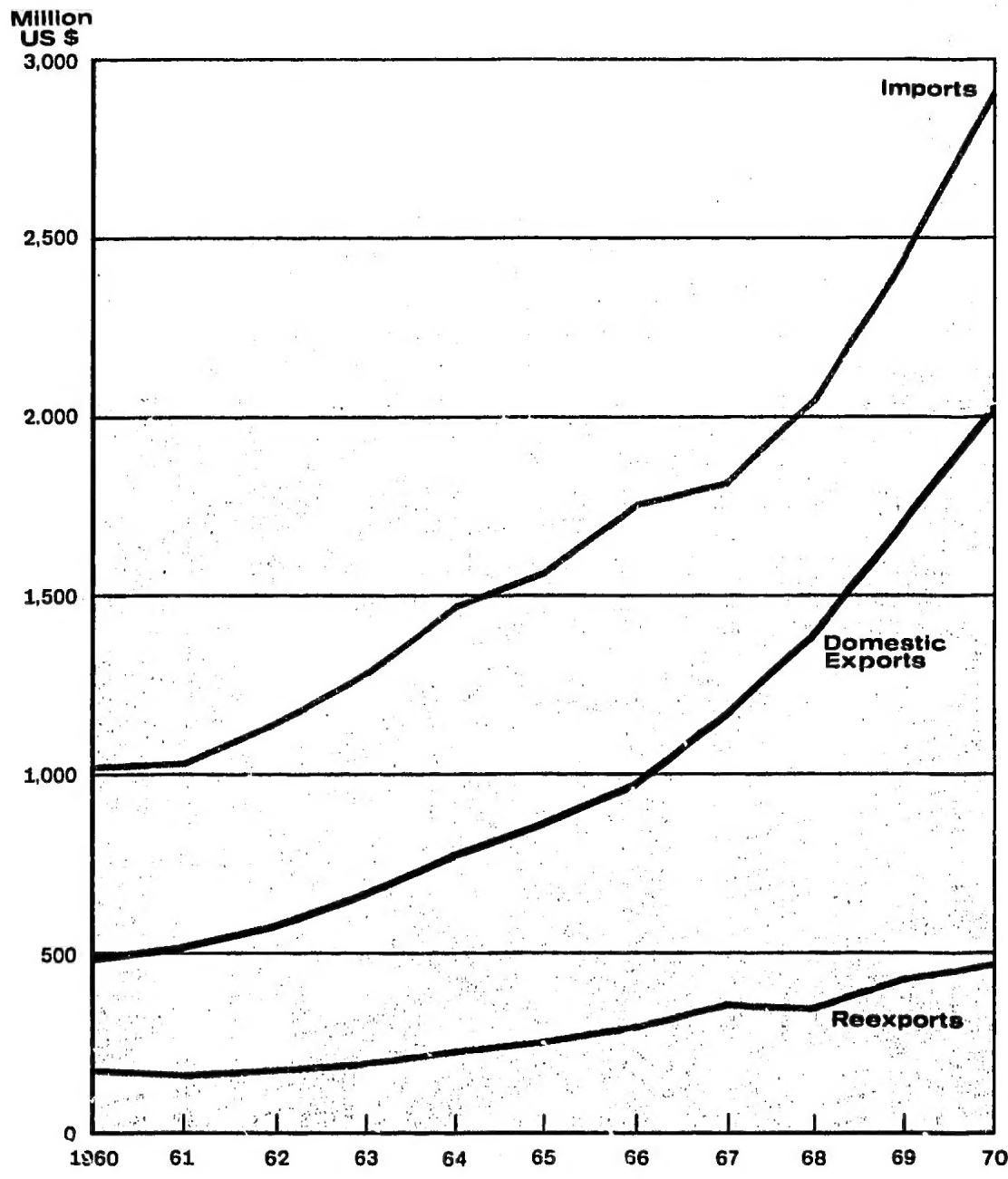
4. Hong Kong leads all other less developed countries in total trade which, at \$5.4 billion, is 27% greater than Communist China's. The colony has grown into the largest textile exporter among the less developed countries, accounting for nearly 40% of their total textile exports. In fact, Hong Kong sells more manufactured textile products abroad than the United States. Among world exporters, Hong Kong ranks first in wigs and plastic flowers, second in clothing and toys, third in transistor radios, fifth in travel

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Hong Kong: External Trade

Figure 1



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goods and handbags, and eighth in footwear, watches, and clocks. Because of its success, the colony is having difficulty maintaining its status as a less developed country, thus causing concern among local businessmen who believe that failure to receive any preferences accorded less developed countries would hurt Hong Kong's competitive position.

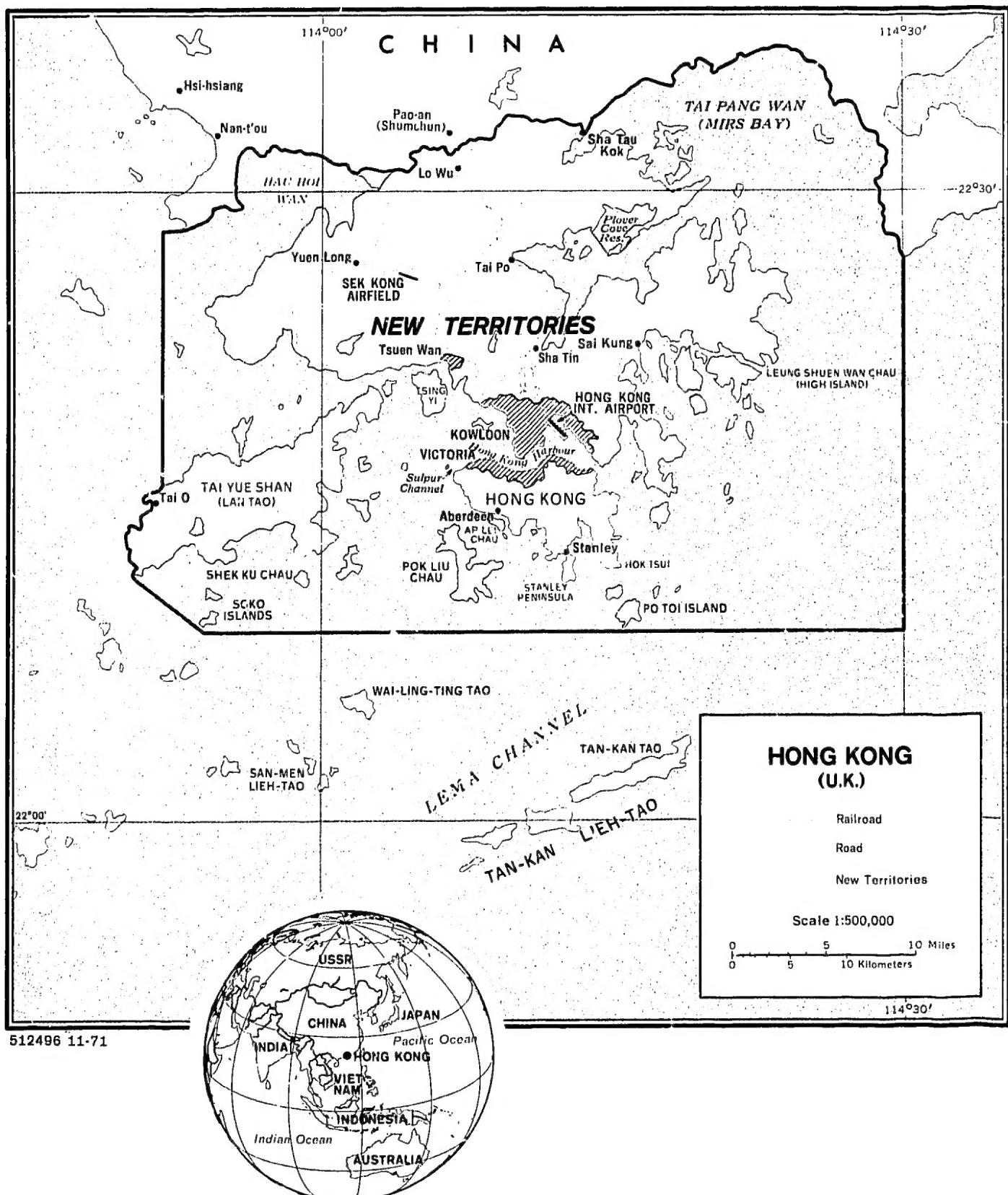
5. In spite of the colony's remarkable prosperity, a basic uncertainty exists because of the circumstances of Hong Kong's origins. Hong Kong Island and part of the Kowloon Peninsula were permanently ceded to the British by the Chinese in 1842 and 1860 while the remainder of the Peninsula, called the New Territories, was leased in 1898 for 99 years (see Figure 2). Should Peking choose to withdraw recognition of these agreements, which were made under duress, the colony could easily be taken over by China. This fact has colored the population's thinking for many years. It accounts for the fact that there is virtually no agitation for independence from Great Britain in the belief that a Chinese takeover is less likely while the colony is under British rule. It is also the reason why all investment and business decisions are based on short-run returns rather than on long-run considerations. Industries that require a significant amount of capital equipment are a rarity, investors preferring small labor-intensive undertakings that can be quickly dismantled or left behind without great loss. For example, so far no company has been willing to invest in an oil refinery despite an urgent need for one, and Hong Kong still imports synthetic fibers, yarns, and fabrics for its textile industry because of unwillingness to invest in a petrochemical industry.

6. Lack of confidence in the status of the New Territories, which include the major part of the 400 square miles controlled by Hong Kong, has discouraged development of these areas. Much of this land stands idle despite the paradoxical situation where land in the center of Kowloon and Victoria sells for Manhattan Island prices. With only 25 years to run on the 1898 New Territories Treaty, entrepreneurs are unwilling to develop properties where the resale value is depressed by the uncertainty of future tenure.

7. Although a constant reminder of colonial days, China has allowed the colony to exist because of its value as a source of hard currency. China will earn some \$500 million from exports to Hong Kong in 1971 and will receive an additional \$200 million, mainly in remittances by overseas Chinese to their mainland relatives. Hong Kong also has some value to China as an intelligence gathering center

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CONFIDENTIAL**Figure 2****CONFIDENTIAL**

CONFIDENTIAL**Bases of Growth**

8. Underlying Hong Kong's economic expansion was the flood of refugees from China which swelled the labor force with skilled and industrious workers including many with entrepreneurial experience and funds to invest. Several waves of migration took place. The first occurred in 1946 when about 1 million migrants from mainland China crossed into Hong Kong, which at the time had a population of only about 600,000. The second major wave began in 1949 as the Chinese Civil War ended and Nationalists fled the Communist takeover. During the next few years, refugees added another million to Hong Kong's population. Although slowing to a trickle at times, migration continued through much of the 1960s, increasing the population to its present level of about 4 million. Although at first presenting horrendous housing and social services problems, these refugees, by and large, have been a valuable asset without which Hong Kong's growth could not have taken place.

9. Other assets are the well-developed services sector and commerce-related industries. A legacy from its long history as an entrepot, the colony's infrastructure includes banks, insurance companies, port and warehouse facilities, merchant shipping firms, and shipbuilding and repair yards. The banking system has a number of large foreign banks, including 13 Communist-owned banks which handle flows of funds into and out of mainland China. Numerous small locally-owned banks are an important source of short-term financing and provide the usual variety of banking services found in an advanced economy. The banking system, however, has not been an important source of investment funds since it generally avoids long-term loans. Local entrepreneurs rely heavily on family savings for investment capital. Only 20% of all loans in the 1960s were made to the manufacturing sector, and the majority of these were short-term. By comparison, 36% were made to finance commerce, and 44% were made to other service industries.

10. Another element in Hong Kong's attractiveness to investors, both domestic and foreign, is the almost total absence of government intervention. Virtually free of all controls, Hong Kong has no restrictions on capital movements either into or out of the colony, no minimum wage laws, few other restrictions on the labor market, and duty free exports. Corporate profit taxes are very low -- about 15% -- capital gains are not taxed at all, and personal income taxes are relatively moderate. This laissez-faire climate has encouraged investment, much of it in highly competitive small-scale firms that are exceptionally responsive to changing tastes in the world's developed countries.

CONFIDENTIAL**Changing Economic Structure and Trends**

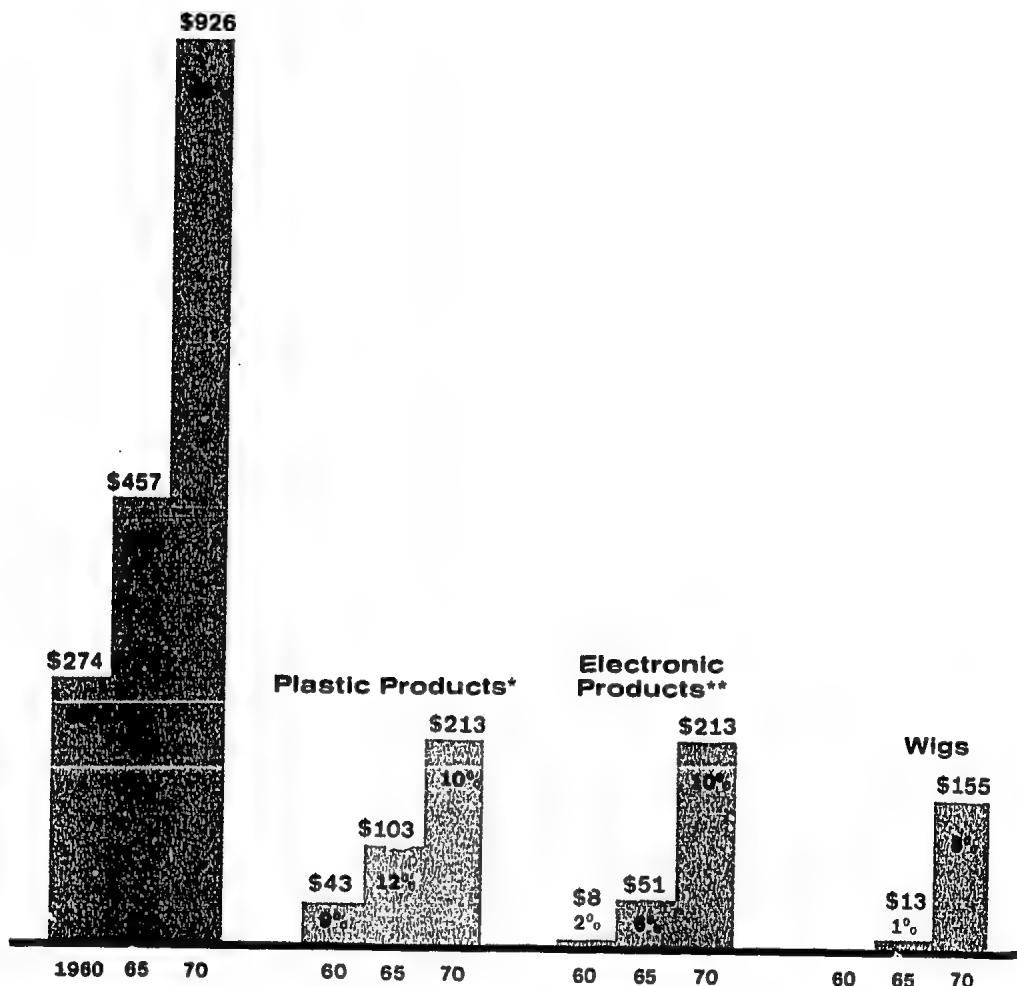
11. Prior to 1950, Hong Kong's economy was based largely on commerce, particularly re-exporting. Industry was small and relatively unimportant except for shipbuilding, ship scrapping, a small iron and steel works, and a few small-scale manufacturing plants. The transformation of the economy from its entrepot orientation began around 1950 when the takeover of mainland China by the Communist regime and the Korean War slowed the growth of Hong Kong's re-export activities which had been based largely on handling mainland goods. Enterprising Hong Kong small businessmen seized the opportunity to manufacture products for the US and other markets. Textile manufacturing was a logical choice for many entrepreneurs both because of their own experience in textile manufacturing and because of the presence of many refugee textile workers. Moreover, the US market could easily absorb all the fabrics and clothing the industry could produce. Later in the 1950s, restrictions on exports of cotton textiles from Japan to the United States further spurred the industry's growth, and during the decade, textiles dominated the manufacturing sector.

12. The economy's rapid growth in the 1960s was led by the very rapid expansion of manufacturing. Exports of manufactured products rose from almost \$500 million in 1960 to about \$2 billion in 1970, when they comprised 81% of Hong Kong's total exports. Re-exports also continued to grow during the period but declined in importance from 27% of total exports in 1960 to 19% in 1970. Much of the re-export growth was in diamonds and other precious and semiprecious stones which increased from \$10 million in 1960 to \$116 million in 1970, when they accounted for almost one-quarter of total re-exports.

13. During the 1960s the textile industry led the economy in value of output as well as in employment, accounting for about 40% of the registered industrial labor force.* The total value of textile sales reached \$926 million in 1970, far exceeding any other category (see Figure 3). Clothing exports account for the major share of textile exports, having increased to \$716 million by 1970. Annual growth rates fluctuated widely as the industry adjusted to changing tastes in styles and materials, but growth averaged 13% per year during 1961-70. The most dramatic and significant change in the textile industry was the trend to clothing made of synthetic cloth which by 1970 accounted for 50% of total garment output, compared with 20% in 1965, while cotton garments declined from half to 30% of the total. Wool garments made up the balance. A shift also occurred away from shirts and underwear to outerwear, which now

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Hong Kong: Major Domestic Exports**Figure 3****Million US \$ and Percent of Total****Textiles**

*Only toys, dolls, and flowers.

**Including transistor radios, components, computer memory arrays, television receivers and subassemblies, and electrical machinery parts.

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accounts for two-thirds of clothing exports compared with less than half in the early part of the decade. This upgrading contributed to the increase in value of exports without a corresponding increase in volume.

14. The flexibility and enterprise of Hong Kong's manufacturers is demonstrated by the speed with which new industries have started. The three most important - plastics, electronics, and wigs - now account for more than one-quarter of domestic exports, having attained this position in a very few years. The plastic products industry, specializing in artificial flowers and toys, is made up of many small factories employing less than 20 workers each and a few large manufacturers. These small firms frequently produce under contract to the large firms, most of which have licensing agreements with US concerns. Exports of plastic products increased an average of about 17% annually during 1961-70, with sales of toys and dolls growing at some 25% per year.

15. Growth was even more rapid in the electronics industry whose sales abroad experienced an average growth of nearly 40% a year. Transistor radios accounted for almost half of total sales, and tubes and transistors for more than one-fifth. Television receiver manufacturing is the fastest growing sector, expanding from only 128 sets exported in 1967 to almost 38,000 sets in 1969. The wig industry is the most recent addition to Hong Kong's major industries. Wig exports increased from \$1.5 million in 1964 to \$155 million in 1970 as wigs grew in popularity, particularly the relatively inexpensive synthetic wigs in recent years. Other domestic exports earned \$530 million in 1970 and accounted for about 25% of domestic exports. The more important of these are manufactured metal products and scientific and controlling instruments.

16. Tourism also grew extremely rapidly during the 1960s. By 1970 the number of tourists visiting the colony had increased by 465% above the number in 1960 as earnings rose to \$282 million. These earnings were second only to those from textile exports. Since 1968, earnings from tourism have more than doubled, although the number of tourists has increased by only 50%. Americans and Japanese are the largest groups by nationality, together accounting for almost half of all civilian tourists. The numbers of US military visitors from the Pacific fleets have declined in recent years and the rest and relaxation program ended in late 1971, but the loss has been more than offset by the growth in civilian tourists.

Trade with the United States

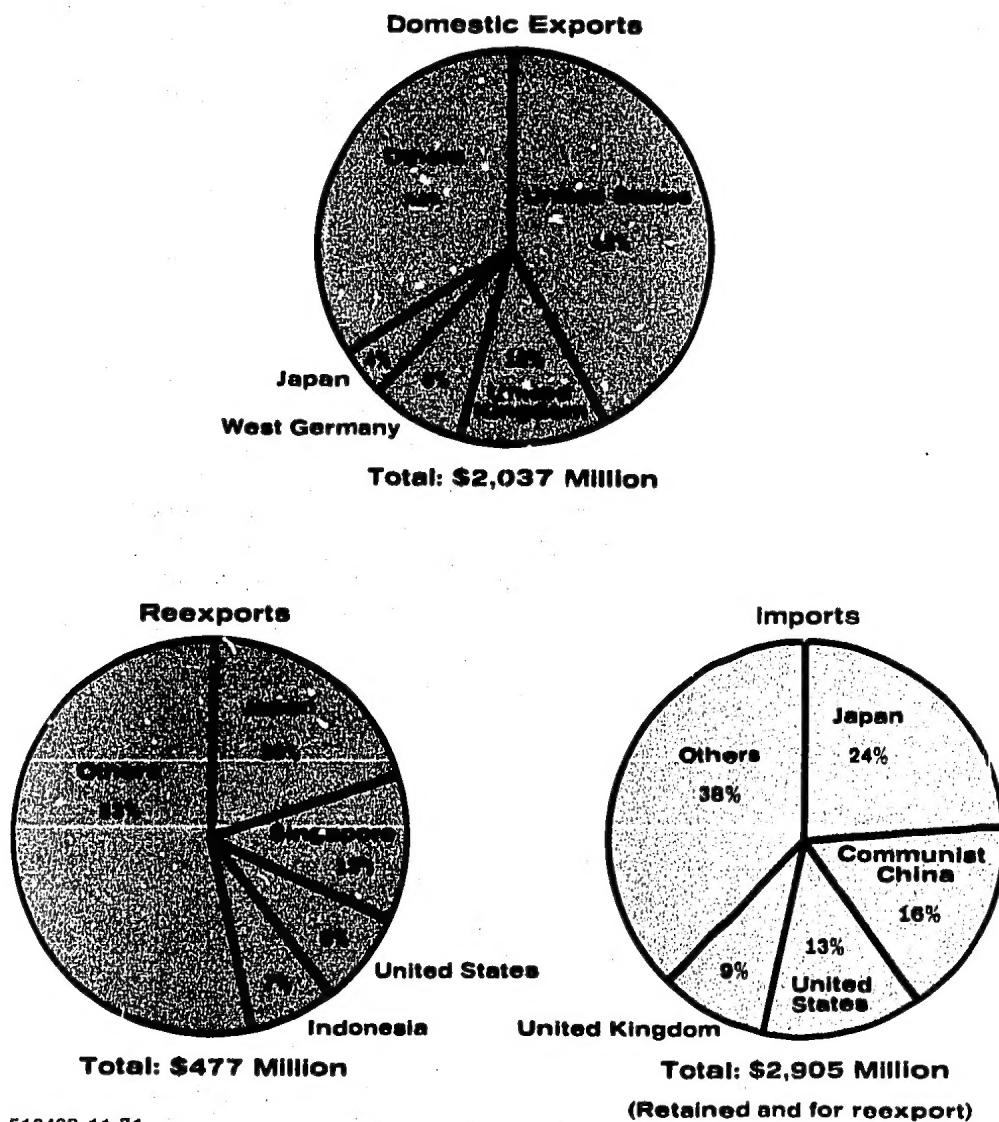
17. Access to the US market has been instrumental in Hong Kong's growth. Some 90% of Hong Kong's manufactured output is exported, and the United States takes over 40% (see Figure 4). Moreover, the United States has accounted for 47% of the growth of Hong Kong's exports in

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Hong Kong: Main Trading Partners, 1970

Figure 4



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the 1960s as US imports rose from \$130 million in 1960 to \$856 million in 1970, an increase of nearly 560%. By comparison, exports to the United Kingdom, Hong Kong's second largest market, grew by only 1.0% during the 1960s from \$102 million in 1960 to \$244 million in 1970. The United States buys two-fifths of Hong Kong's clothing exports; two-thirds of its electrical, electronic, and plastic manufactures; and three-fifths of its wig exports.

18. The United States is less important as a source of Hong Kong's imports. Possessing almost no natural resources, Hong Kong must import almost all of its raw material needs as well as much of its fibers, yarns, and fabrics (particularly synthetics for its textile industry), foods, scientific equipment, and transport and heavy equipment. Japan supplies almost 24% of Hong Kong's imports, China 16%, the United States 13%, and the United Kingdom 9%. Japan is the major supplier of textile yarns and fabrics, as well as transport equipment and machinery, while China is an important supplier of all kinds of foods. The United States sells Hong Kong electronic components for incorporation in electronic manufactures, unset diamonds, light industrial machinery and transport equipment, pharmaceuticals, and foods, including fruits and vegetables.

19. US investment in Hong Kong totals about \$340 million, of which about \$45 million is in manufacturing. The bulk of the remainder is in a powerplant and the rest in sales, services, and petroleum facilities. US investment in manufacturing is more extensive than the amount suggests because of the relatively small investment required in Hong Kong's non-capital-intensive industries. Much US investment is in firms manufacturing components or finished products for American firms for the US market. This is especially true of electronics where three-quarters of US investment in manufacturing is concentrated. The United States has virtually no investment in textiles, although about 20% of total foreign investment - largely Japanese and UK investment - is in this industry. In addition to industrial investment, foreigners also hold roughly one-half of the \$2.5 billion in Hong Kong banks.

Problems and Prospects

20. Hong Kong's prosperity is almost certain to continue, although some slackening in the growth rate is anticipated. The slowdown will reflect the problem of rising labor costs, particularly in the textile industry, and increasing competition from lower-wage countries such as Taiwan and South Korea. South Korea's and Taiwan's share of clothing exports to the US market rose from 5% of US clothing imports in 1965 to 25% in 1970 while Hong Kong's share expanded only marginally from 22% to 23%. Deterioration of Hong Kong's competitive position has become more serious in recent years as wage rates increased rapidly. From 1965 to 1970, wages

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rose by 56%, and more than half of the increase occurred in the last two years. Wage rates in the textile industry are now roughly twice those of South Korea and considerably higher than in Taiwan.

21. Because of the volatile nature of the economy and the relatively small capital investment in most manufacturing firms, the colony is especially sensitive to an economic downturn. Rising wages have already encouraged some local firms to establish subsidiaries in Taiwan and South Korea to take advantage of lower wage rates. A deterioration in the colony's competitive position would affect inflows of foreign investment funds. Incipient signs may be the recent increases in foreign investment in Taiwan, South Korea, and Singapore, apparently in preference to Hong Kong.

22. Hong Kong's dependence on the US market is another factor that adds to the precariousness of Hong Kong's prosperity. The colony's extreme vulnerability to US market conditions is reflected in the colony's present recession. In the first half of 1971, wig exports declined 30% from the level of the same period in 1970, and sales of artificial flowers declined by 21%. Even exports of electronic products increased by only 10% in the first half of 1971, over the first half of 1970, compared to 22% for all of 1970 and an average annual growth rate of about 40% in the 1960s. Hong Kong's prosperity is also dependent on US policy, as demonstrated by the recent adoption by Hong Kong of controls on textile exports.* The close relationship with the United States has served Hong Kong well in the past, but the colony is worried that its advantages are beginning to diminish.

23. The only alternatives to the US market are the EC countries and Japan, which could take a larger share of Hong Kong's exports. As a less developed country, Hong Kong is included in the EC's generalized preference scheme. Preferences do not apply to textiles, however, and limits are placed on imports of all of Hong Kong's major products. Japan does not accord preferences to Hong Kong, but Hong Kong's exports still have a competitive edge on the Japanese market. The Japanese, however, severely limit Hong Kong goods through formal and informal controls.

24. Hong Kong is well aware of these weaknesses and their potential danger to future prosperity. To meet the challenge of slowing growth, Hong Kong's businessmen are buying more efficient production equipment and are making a determined effort to upgrade the design and quality of their products and to diversify into new products and new markets. This trend

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was largely responsible for the increase in retained imports of capital equipment in 1970, which totaled \$313 million, a 47% increase over 1969. This trend is likely to continue for some time. The effect on production costs is not yet apparent, but it almost certainly will improve the competitive position of Hong Kong's exports.

25. In future years, Hong Kong can be expected to follow the classical pattern of developing countries. Wage increases will force an upgrading of products and increased investment in capital equipment, but a general movement into large capital-intensive industries is unlikely because of lack of land and fears of a Chinese takeover. The dependence on light manufactures is an advantage to the resilient Hong Kong businessmen because they can easily switch into new product lines to meet shifting demand patterns. In fact it is this flexibility which will provide the stimulus for continued economic growth.

26. Investor confidence in Hong Kong's political future would probably increase should the developing detente between China and the United States continue. Moreover, the emergence of China in the world community justifies a degree of optimism in regard to Hong Kong's security, and this should also increase investor confidence, in spite of the possible loss of the colony's remunerative entrepot function should China develop direct trade relations with the West.